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Study on Fiscal Imbalance of Tamil Nadu, India

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Abstract

The study focused on Fiscal imbalance and its adverse effects on macroeconomic equilibrium in India have been receiving wide attention; the issue at States' level has not so far been adequately analyzed. In many respects, fiscal situation in States is more critical than that at the Centre as States have the Constitutional responsibility for providing basic social and economic services, yet, do not have independent power to borrow from the market or the central bank. Given these constraints, the burden has tended to fall on capital and maintenance expenditures with adverse implications emphasizes the differences between fiscal sustainability analysis at the national and sub national levels, attempts to take into account uncertainty, and discusses the key components of the state's fiscal accounts and how they respond to reforms and shocks. Risks to Tamil Nadu's fiscal outlook include interest rate shocks, pressures on the primary balance, and contingent liabilities.

Keywords: Fiscal Imbalance, State Taxation, Tamil Nadu

Introduction

It is a fact that, the Centre, several States are also facing deteriorating budgetary positions, with serious implications on their developmental efforts. Insufficient revenue sources, uncontrolled growth of current expenditures, and failure of central transfers to grow as fast as the States' own revenues have been the sources of the imbalances. In many respects, the fiscal situation in the States is more critical than that at the Centre as the States have the primary Constitutional responsibility for providing basic social and economic services. At the same time, while the elasticity of own revenues of the Centre and the States are broadly the same, the States' expenditures have been growing at rates faster than that of the Centre particularly in recent years. There is not only a shrinking of capital expenditure, but the maintenance of existing capital assets is also not getting its due. Other signs are raising trend of non-developmental consumption expenditure, high cost of government employees' especially after the implementation of the Fifth Central Pay Commission. At the State level, there is an increasing trend in the volume in government employment thereby burgeoning rise in wages and salary bill apart from rise in debt servicing. From the receipts angle, poor tax collections, poorly targeted cost recovery policy and lack of desired tax reforms adversely affect the income buoyancy of the taxes that put constraints on expenditure needs from own revenue sources of the States. This leads to dependence on higher level governments for larger fiscal transfers and also on ways and means advances. Besides, public sector enterprises (PSEs) are largely in a financial mess requiring huge doses of budgetary support to sustain them. These are some of the worrisome factors among others. If the same fiscal trends follow, the fiscal deficit is likely to assume disquieting proportions due to an increasing component of revenue deficit to be financed from borrowings. Hence, there is need to strengthen the revenue-effort and restructuring of expenditure for sustainability. It is a tough challenge to all the governments.

In the Indian federal set up, the States play an important role in accelerating and sustaining growth. Federal forms of government are a time-tested way of organising states. They are generally motivated by the need to accommodate territorially based ethnolinguistic and other socio-cultural diversities within a single political unit. There are also some fairly compelling economic arguments in favour of federalism. First, there can be substantial efficiency and welfare gains from decentralisation of spending responsibilities [Tiebout 1961; Musgrave 1969; Oates 1972]. Second, decentralisation can help ensure efficiency in the production of public goods. Decentralisation can act as a surrogate for market discipline in ensuring efficiency in the production of public goods

As our analysis would show, the rapidly rising fiscal deficit and debt levels in Tamil Nadu, and other Indian states, were troubling because the new borrowing over the period was used to finance revenue deficits crowding out fiscal space for infrastructure investment. The experience of Tamil Nadu in its quest for fiscal sustainability is relevant for sub national governments in other countries. Decentralization has given sub national governments in developing countries significant spending and taxation responsibilities, and the capacity to incur debt. Unsustainable fiscal policy at the sub national level jeopardizes service delivery, the safety of the national financial system, and macroeconomic stability.

The paper is presents the analytic framework for fiscal balance analysis at the sub national level, and emphasizes the differences between sub national and national fiscal adjustments and discusses the fiscal deterioration in Tamil Nadu in the late 1990s and analyzes the key components of the state's fiscal accounts. The section also discusses the outcomes of the fiscal reforms promoted in response to this deterioration.

States' own tax revenues

States' own taxes can be grouped into three parts, *viz.,* (i) taxes on commodities and services such as sales tax, State excise, taxes on vehicles and taxes on goods and passengers, (ii) taxes on property and capital transactions such as stamps and registrations and land revenue, and (iii) taxes on income such as profession, trade and agricultural income. Among the above, the principal sources of States' tax revenue are sales tax, State excise and stamps and registration fees. Sales tax alone accounts for nearly two-thirds of the total States' own tax revenue. Realising the need for tax reforms, many States have switched over to a Value Added Tax (VAT) regime on the basis of the recommendations of the Empowered Committee of State Finance Ministers with effect from April 1, 2005. VAT may be defined as a tax on the value added at each stage of production and distribution of a commodity.

India's sub national borrowing regime and Tamil Nadu

The Indian Constitution forbids states from borrowing abroad and requires them to obtain central permission for domestic borrowing. The central government places informal limits on states' borrowing through the annual discussions with states on financing state development plans. While limiting explosive growth of state debt, the central government has not succeeded in preventing the states' fiscal deterioration as indicated by high levels of debt and debt service over revenue in many states. Bargaining between the center and the states has often prompted the center to give additional loans or relax borrowing limits. Furthermore, since the late 1990s, many states have circumvented the borrowing limits by accumulating arrears or issuing guarantees to public enterprises' market borrowing or newly-created special purpose vehicles.

The state borrowing regime in India is complex. There are multiple borrowing channels each channel with its own rules. The states can obtain market financing, loans from the central government, and financing from employees' provident fund although market borrowing, from the bond market, national small savings fund, and negotiated loans with public-sector financial institutions, has increased in importance, accounting for more than half of sub national borrowing, market discipline is absent. Market loans in India

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are not pure market-based lending for two reasons. First, market loans are dominated by public commercial banks which have persistently exceeded the statutory requirement of holding government bonds, effectively crowding out private investment. Commercial banks' holding of government securities grew from 14 percent of combined liabilities of the consolidated government to 25 percent between 1991 and 2004.Second, interest rates on government bonds are the same for all states independent of creditworthiness. States typically approach the market together, and the Reserve Bank of India (RBI) reportedly pushes creditors to buy a mix of state bonds with the better managed states subsidizing the worse-managing states. In 1999, RBI allowed market borrowing up to 35 percent of a state's total market borrowing allocation. But in reality, state-specific auctions are declining not increasing (World Bank,2005b).

Summary results of the status during 1999-2006

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
GSDP(Rs.crore)	118959	137431	158,637	183,119	211,373	243,986	281,630
Total receipts	16.1	16.0	15.9	15.8	15.8	15.8	15.87
Own source receipts	12.3	12.3	12.3	12.3	12.3	12.3	12.3
Tax	10.3	10.2	10.4	10.5	10.5	10.6	10.7
Non tax	2.1	2.0	1.9	1.9	1.8	1.7	1.7
Centrals transfers	3.8	3.7	3.6	3.5	3.5	3.4	3.4
Balances							
Fiscal balance	-4.4	-4.7	-5.0	-5.3	-5.7	-6.1	-6.7
Revenue balance	-2.7	-3.1	-3.5	-3.9	-4.4	-4.9	-5.5
Primary balance	-2.7	-2.7	-2.8	-3.0	-3.2	-3.5	-3.8
Debt outstanding	20.6	22.5	24.3	26.1	28.1	30.2	30.7
Debt service/revenue (%)	9	10	11	12	12	13	14

Source: Projection based on actualized for 1999-00

The most important source of rising current expenditure has been wages and salaries. Fiscal reforms should aim at reducing the rate of growth of government employment to at least the same level as the rate of growth of population. Currently, the rate of growth of government employees' in Tamil Nadu is over 3 percent per annum while population growth rate is just 1.37. The reforms will aim at bringing the current elasticity of government employment with respect to population from the existing 2.25 to unity.

In recent years, that is, from 1993-94 onwards, however, the rate of growth has been only about 6 percent per annum. Under the reform scenario, the annual growth rate of subsidies is to be brought down to 1.3 percent so that the expenditure on subsidies grows exactly in tandem with the size of population. As regards transfers, over 70 percent of current transfers other than subsidies and other transfers are grants to local bodies. Even so, compensation and assignments to local bodies formed less than 2 percent until 1996-97. The First State Finance Commission has recommended devolution of 8 percent of State's own tax revenues net of collection costs to local bodies for 1997-98, gradually increasing by one percent annually to 12 percent in 2001-02. The reform scenario is worked out on the assumption that these recommendations will be adhered to.

There is also a need to step up the operation and maintenance expenditure for replacement of aged and worn out assets particularly, in the irrigation and roads sectors. It is assumed that one of the reforms will be to see that the present low elasticity of operation and maintenance expenditure at around 0.62 will be gradually doubled by 2005-06. This will considerably reduce the spending gap in respect of maintenance of roads and bridges.
On the revenue side, the buoyancy of the taxes on agricultural sector will be stepped up from the present 0.71 to unity level. As regards the commodity taxes (sales tax and state excise), without widening the base and adopting the VAT system applicable to goods as well as services, it may not be possible to raise more revenue. Revenue yield is likely to improve with the introduction of VAT because of improved transparency leading to better compliance. With these reforms, it is assumed that the commodity tax buoyancy will be raised up from 1.05 to 1.2.

In view of the large and persistent resource gap, the cornerstone of the fiscal strategy pursued at State level needs to be examined as per the changing requirements. As rightly stated in the Mid Term Appraisal of the Tenth Five Year Plan 2002-07, Government of India, *"Improving resources of States on a sustainable basis, providing incentives for developmental performance, fiscal prudence and accountability and putting in place successful and flexible mechanisms for intergovernmental transfer are key issues, not only in the remaining period of the Tenth Plan but even more for the Eleventh Plan".* Although the baseline points to a sustainable debt path for Tamil Nadu, there are significant risks that may derail the state's progress along this path. Key risks are potential increases in real interest rates, constraints to primary balance adjustment, and sudden realization of contingent liabilities.

Conclusion

The present's paper concluded sub national fiscal sustainability and applies it to the case of Tamil Nadu - an Indian state where fiscal adjustment has been ambitious and politically challenging, but has promised to put state finance on a sustainable path. The analysis suggests that the fiscal adjustment in Tamil Nadu has left fiscal space for increases in infrastructure investment which may be achieved without threatening fiscal sustainability. Though the fiscal management of Tamil Nadu seems comparatively better, yet there is scope for and need to strengthen its revenue-effort and restructuring of expenditure for sustainability. If the same fiscal trends follow, the fiscal deficit is likely to assume disquieting proportion due to increasing component of revenue deficit. Assessing fiscal sustainability is a complex task as it requires one to form a view about how much fiscal adjustment is politically and socially feasible in the future, and how the outstanding stocks of liabilities are going to evolve over time. These, in turn, depend on macroeconomic and financial market developments that are uncertain by nature.

Policy measures towards states' taxes

The general approach of the States has been to rationalize and simplify the tax structure, broaden the tax base and impose moderate rates of taxation. States have initiated policy measures towards fiscal empowerment mainly through States own taxes and showed intention to increase the magnitude and efficiency of tax revenue mobilization over the years.

Introduction of VAT

Realizing the need for tax reforms, most of the States have switched over to a VAT regime on the basis of recommendations of the Empowered Committee of State Finance Ministers with effect from January 1, 2007. VAT may be defined as a tax on the value added at each stage of production and distribution of a commodity. VAT is inherently efficient than the sales tax or excise duty or any turnover tax. Operationally, application of VAT at a particular stage implies payment of tax by the producer or distributor on the value of his output but with a rebate (or credit) on the taxes paid by him on the inputs.

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